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**FROM FINANCIERISTIC TO REAL  
MACROECONOMICS: SEEKING  
DEVELOPMENT CONVERGENCE IN EEs**

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**From Financieristic To Real Macroeconomics:  
Seeking Development Convergence In Ees**

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**Abstract**

There is a broad consensus that macroeconomic “fundamentals” are a most relevant variable to enhance economic development. However, there is wide misunderstanding about (i) which are the “sound macroeconomic fundamentals”, contributing to a sustained high economic growth, and (ii) how to achieve and sustain them.

The approach that has been in fashion in the mainstream world and IFIs emphasizes macroeconomic balances of two pillars: low inflation and fiscal balances. We call it financieristic macroeconomic balances. Additionally, a frequent assertion in the more recent conventional literature is that an open capital account contributes to impose macroeconomic discipline in EEs. Indeed, this approach assumes, frequently implicitly, that full opening of the capital account automatically generate an aggregate demand consistent with productive capacity.

That approach implies a clear omission of the overall macroeconomic environment for producers, which includes other most influential variables such as consistency of aggregate demand with potential GDP, and interest and exchange rates. As a consequence, in many emerging economies (EEs) “a sound macroeconomics” (low inflation and fiscal discipline) is observed, in parallel with slow growth and high unemployment of labor and of productive capital resulting from unstable aggregate demand and outlier interest and exchange rates.

The standard approach evidently includes other ingredients, but assumes, that the hard, relevant, proof is in fulfilling those two pillars. The belief is that that couple leads to achieving productive development if the economy is liberalized.

There is strong evidence that financial macroeconomic balances have provided a macroeconomic environment that has not contributed to a high and sustained growth. A third pillar must be added, linked to the productive side of the economy. The behavior of aggregate demand, at levels consistent with potential GDP (productive capacity or production frontier), is a crucial part of a third pillar of real macroeconomic balances, which has frequently failed in neo-liberal experiences. Similarly, are well-aligned macro-prices, like interest and exchange rates. Frequently, these prices and aggregate demand have behaved as outliers (out-of-equilibrium), as reflected in economies working either

below potential GDP (the most frequent result), or overheated, with a booming aggregate demand and a large external deficit.

This article will widen the view on macroeconomic balances by taking into account the macroeconomic incentives faced by firms and workers in the productive side of the economy (the producers of GDP), and the inter-relationship between financial and real variables. We analyze alternative structural countercyclical fiscal policies, intermediate exchange rate policies, and capital account approaches.

**Key words:**

Financieristic, Macroeconomics, Development.

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\* These issues are discussed in further detail in *Reforming Latin America's Economies after Market Fundamentalism*, Palgrave Macmillan, New York, 2006. Cited here as F-D (2006). I appreciate the valuable contributions of Heriberto Tapia and the research assistance of Rodrigo Heresi.

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## INTRODUCTION

The successful control of inflation and budget deficits has been a generalized trend among Emerging Economies (EEs) in the last two decades. However, the economic and social performance of many of those economies has been disappointing over that period. In spite of the theories that predict development convergence with developed countries, a significant part of the developing world has been diverging and experiencing a worsening in its already-unsatisfactory social indicators, like poverty and income distribution. As a matter of fact, while the East Asian economies have been converging with annual rates of growth in per capita GDP of 3.8% in 1990-2007 (compared to one of 1.7% in the United States), Latin America has been diverging with a modest annual average growth of 1.5%.

One main cause of the poor performance of several EEs is the absence of a comprehensive approach to macroeconomics, beyond the necessary emphasis in the control of inflation and budget deficits. Moreover, in some countries (particularly in Latin America), the explicit consideration of the real side of the economy has been disregarded. This narrow view played a negative role in the implementation of liberalizing economic reforms (see Ffrench-Davis, 2007), and it still underlies the design of macroeconomic policies in place and policy recommendation from IFIs.<sup>1</sup>

Real macroeconomic balances are crucial for achieving a more dynamic development with equity. Consequently, the relevancy of learning how these balances are obtained, how sustainable and comprehensive are they, how consistent are they with *macrosocial* balances, and how do they affect the variables underlying potential GDP (GDP\*).

From the productive point of view, efficient macroeconomic policies must contribute to: i) the use of the available productive capacity, raising the level of utilization of labor and capital, in a sustainable manner; ii) foster capital formation, and iii) increase productivity by furthering improvements in factors quality and in the efficiency of their allocation. These are the three cardinal elements that can generate endogenous growth and determine the economic growth rate during the transition to a new stationary level.<sup>2</sup>

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<sup>1</sup> See, for example, Singh (2006).

<sup>2</sup> Somewhat related discussions can be found in Agénor and Montiel (1996); ECLAC (2004); Easterly, Islam and Stiglitz (2001).

A high average rate of use of capacity implies reconciling the levels of actual aggregate demand and potential supply, attaining a suitable mix between tradables and non-tradables, and achieving appropriate macroeconomic relative prices, such as interest rates and exchange rates. They are key variables for fulfilling development objectives. Capital formation and actual total factor productivity (TFP) of that capital are vitally dependent on the quality of those balances.

If macroeconomic policies are to make the most effective contribution to development, it is necessary to adopt a comprehensive overall view, (i) that systematically takes account of their effects on productive development; (ii) which reconciles the macroeconomic and macrosocial balances in a similarly integrated manner, and (iii) that gives rise to trends which are sustainable in time.

This paper takes the experience of the Latin American Countries (LACs) as a paradigmatic case in terms of the effects of a “financieristic” approach in macroeconomic policy-making. The performance of LACs has been driven by a macroeconomic environment where the main agents –government, entrepreneurs, workers, investors– have been facing sizable fluctuations in aggregate demand, economic activity, and macro prices. Significant successes in reducing inflation and improving fiscal responsibility have failed, by themselves alone, in achieving stability in the environment met by producers, both labor and capital.

Consequently, though overall GDP also responds to complex processes related with micro and meso structures, macroeconomics has been one main factor behind the volatile and disappointing behavior of regional output. This has been a severe failure in LACs economies, which requires a sharp correction. It is crucial to avoid or soften deep and long-lasting recessions, as well as to ensure a sustainable evolution of the main macroeconomic variables during boom periods: external and fiscal accounts, domestic and private indebtedness and, in general, a convergence between aggregate supply (the potential output or productive frontier) and effective demand.

This paper focuses on the definition of macroeconomic balances, and their overall impacts on growth and equity. Since capital flows have played a dominant role in the emerging economies during the last third of the century, their effects will take a central role in the discussion.

Section 1 defines macroeconomic balances for sustainable growth; the analysis leads to two contrasting approaches to macroeconomic balances, emphasizing the relative weight of real



versus financial factors in economic decisions: a two-pillar *financieristic* balance, and a three-pillar real macroeconomics for development. It explores why financial instability has significant real permanent effects (with references to the Latin American experience), via the gap between potential GDP and its actual utilization (called here *output gap* or *recessive gap*); the positive dynamic implications, for capital formation and actual productivity (TFP), of holding low output gaps are stressed. Section 2 examines the connection between external shocks and the macroeconomic environment, highlighting the challenges of policy-making to deal with the real business cycle, and destabilizing intertemporal macroeconomic adjustments. Section 3 analyses the role played by short-term segments of financial markets and the predominance of financial investments (speculation and rent-seeking) at the expense of productive activities. Section 4 summarizes a set of key considerations on macroeconomic policies to achieve comprehensive macroeconomic balances, consistent with higher and sustained economic growth with equity; includes monetary, exchange rate and fiscal policies, and the regulation of capital flows. Section 5 concludes.

## 1. REAL MACROECONOMIC BALANCES

There is a broad consensus that macroeconomic 'fundamentals' are a most relevant variable to enhance economic development. However, there is wide misunderstanding about what constitutes "sound fundamentals", and how to achieve and sustain them.

The operational definition of macroeconomic balances has become so narrow that in many EEs (and particularly LACs, as explained below) the coexistence of "a sound macroeconomics" is observed, mirrored in low inflation and small public deficits or surpluses, in parallel with slow growth and high unemployment of labor and capital resulting from unstable aggregate demand and outlier interest and exchange rates. This section widens the view on macroeconomic balances by taking into account the macroeconomic incentives faced by firms in the productive side of the economy, analyzing also the relationship between financial and real variables, and the *social* effects of macroeconomic policies.

### a) *A two-pillar macroeconomics*

The approach that has been in fashion in the mainstream world and IFIs, even up today, emphasizes macroeconomic balances of two pillars: low inflation and fiscal balances. It depicts a

clear omission of the overall macroeconomic environment for producers, which includes other most influential variables such as aggregate demand, and interest and exchange rates. We call it financieristic macroeconomic balances.

This approach evidently includes other ingredients, but assumes, that the hard, relevant, proof is in fulfilling those two pillars. It assumes that achieving the two pillars leads to productive development if the economy is liberalized (that is with the addition of microeconomic reforms, several of which have been in fact made). This approach has been in place for about two decades and continues to be the basis of the “remaining agenda” pushed by the IFIs (see, for example, Singh, *et al.* (2005); Singh (2006), IMF Director for the Western Hemisphere). Additionally, a frequent assertion in the more recent conventional literature is that an open capital account imposes macroeconomic discipline to EEs.<sup>3</sup> Indeed, this approach assumes, sometimes explicitly or frequently implicitly, that full opening of the capital account would contribute to impose external and fiscal balances and, as a consequence, automatically generate an aggregate demand consistent with productive capacity: it is well documented that that is not the usual experience in the frequent cases of external, positive and negative, financial and terms of trade shocks experienced by EEs (see F-D, 2006, ch. VI; Williamson, 2003).

Naturally, concern for those two financial balances is justified. In particular, several LACs have suffered from hyperinflation: a phenomenon that, when alive, tends to occupy such a dominant place that anti-inflationary policy often becomes the leading and absolute objective of economic policies. Hyperinflation processes (see figure 1, panel C) have been the consequence of public deficits out of control and money printing to finance them.

LACs were successful in the 1990s in reducing inflation to one-digit figures, and balancing their fiscal budgets (fiscal deficits averaged, of course with diversity among countries, between 1 and 2% of GDP in 1994 and 1997, the two years preceding the two recessive shifts of the 1990s).<sup>4</sup> Expansions of the money supply to finance public expenditure had become weaker

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<sup>3</sup> A recent working paper of the IMF (Tytell and Wei, 2004) examines the “discipline effect” of financial globalization on macroeconomic balances, focusing on the two pillars in fashion –low inflation and fiscal balances– disregarding the other components of a comprehensive set of real macroeconomic balances.

<sup>4</sup> It is inconsistent to assert that fiscal deficits have been the cause of currency or financial crises, on the basis of fiscal figures that refer to the period after the explosion (for instance to 1998-99). Obviously, that is not a cause but a consequence of crises.

or disappeared. Thus, several LACs fulfilled the main requirements of neo-liberal macroeconomic balances (see panels C and D in figure 1).<sup>5</sup>

[Figure 1]

Clearly, the two-pillar macroeconomics was not enough. At the same time there was an increasing external deficit (see panel A in figure 1) that implied a rising degree of vulnerability. In boom periods, the excess of expenditure over domestic production or income was concentrated in the private sector (Marfán, 2005). In fact, in boom stages, while the external deficit worsened (financed with capital inflows), the public sector of many countries in the region registered a marked improvement between the decade of the eighties and the nineties until the arrival of the contagion of the Asian crisis. The growth of current account deficits was frequently caused by the increased net expenditures of the private sector in the 1991-98 period. This outcome was the combined result of the large supply of foreign financing and the permissive domestic macroeconomic policies, usually praised by financial markets. Consequently, after the international turbulences of 1994 (Tequila crisis) and 1997-98 (Asian crisis), a significant recessive output gap reopened, with severe costs for growth and equity (see Ffrench-Davis, 2007).

*b) Toward real macroeconomic balances: three pillars*

Financial macroeconomic balances are not sufficient to achieve a macroeconomic environment for high and sustained growth. A third pillar must be added, linked to the productive side of the economy. The behavior of aggregate demand, at levels consistent with potential GDP (also called productive capacity, installed capacity or production frontier), is a crucial part of a third pillar of real macroeconomic balances, which has frequently failed in neo-liberal experiences. As well, are well-aligned macroprices, like interest and exchange rates. Frequently, these prices and aggregate demand were outliers (out-of-equilibria), as reflected in economies working either

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<sup>5</sup> Also, economic reforms succeeded in improving export dynamism. However, trade reforms during episodes of appreciating real exchange rates ended up, frequently, in an excessive destruction of tradable activities whose output was directed to domestic markets. Likewise, export development has remained too concentrated in commodities with low value-added, which limits the transmission of export dynamism to the rest of the economy (see Agosin, 2007; F-D, 2006, chs. IV and V; Ocampo and Parra, 2007).

quite below potential GDP (the most frequent result) or, at full capacity but with a booming aggregate demand and a large external deficit.

One of the most fundamental macroeconomic balances refers to the rate of utilization of productive capacity. In economies with inflexible price systems and *incomplete* factor markets, both positive and negative shocks provoke successive adjustments. The results are greater disparity between supply and aggregate demand, with a consequent gap between potential productive capacity and the use made of it, particularly in the “stop” stages that follow the “go” stages. Unstable demand, in a stop-and-go setting, inevitably means **a lower average net use of productive capacity and a lower average actual productivity** than those of a situation of stable proximity to the productive frontier. Naturally, the larger the instability, the larger will be the recessive output gap.

c) *Instability, growth and equity*

Behind the emergence of output gaps is the extreme instability in GDP growth rates. As shown below, in figure 4, Latin America has faced volatile business cycles, with intense contractions and expansions. Evidently, the production frontier poses a limit to recoveries of actual GDP; only temporarily actual GDP can exceed potential GDP. While in recessive situations, actual GDP can be notably below potential GDP. The implication of this annoying asymmetry is that average actual GDP, under real macroeconomic instability, is significantly lower than the average production frontier. This asymmetry, intrinsic to economic reality, has significant implications for defining doses of objectives and policies, and for empirical research and econometrics (see F-D, 2006, ch. III, section 2).

The magnitude of the gap between effective demand and the production frontier has important static and dynamic effects. First, it affects the *ex post* productivity and profitability of the projects implemented. Second, indeed, higher rates of capital utilization mean that the average level of employment is higher and that the labor force combines with a larger stock of physical capital in actual use. Higher actual productivity does mean that the potential welfare of labor and rentiers (wages and profits) can improve at present, with the higher average rate of use of capacity. If wages and profits grow, then fiscal revenue will grow as well. Then, workers, entrepreneurs and government will be able to sustain higher consumption and investment, with a net positive effect on overall economic welfare.

Third, in the dynamic dimension, there are several effects of the degree of stability. Higher rates of utilization and the consequent increase in actual average productivity (in standard econometrics it would appear as a rise in TFP), will tend to stimulate investment in new capacity (Gutiérrez and Solimano, 2006).<sup>6</sup> For the supply of investment to expand effectively, investors must perceive a real improvement in the short term and foresee that the reduction in the recessive output gap will be persistent (sustained in the future). The dynamic effect will be all the more significant if solid expectations are generated, among the economic actors, regarding that public policies will keep effective demand close to the production frontier, and if, in addition, authorities undertake reforms to *complete* long-term capital markets, and enhance labor training and productive innovation.

Figure 2, shows the close association between the output gap and capital formation in Latin America, reflecting one of the main negative effects of the underutilization of productive factors. This connection responds to several factors:<sup>7</sup> (i) if there is plenty of idle capacity, then there is less incentive to invest in new productive assets; (ii) volatile environment deters irreversible investment (Pyndick, 1991); (iii) the recessive gap and its fluctuations tend to deter the quality of project evaluation and innovation; (iv) intense economic fluctuations tend to depress government revenues, which induces cuts in public investment, as discussed below.

[Figure 2]

Consequently, there is a clear connection between real volatility and long-term economic growth, which works through its effects on actual TFP and on the volume of investment in fixed capital.<sup>8</sup> Figure 3 shows the relationship between the growth of the stock of capital and of GDP (both variables measured per member of the labor force) for 26 economies, including 19 LACs, six East Asian countries and the United States. In order to try to control for changes in the rate of

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<sup>6</sup> One significant explanatory variable of the low investment ratio recorded in Chile in 1974-89 (the Pinochet Dictatorship), is the large average output gap predominating in that period. See Ffrench-Davis (2002, ch. 11). The large size of the gap is associated to sharp and abrupt drops with gradual macroeconomic recoveries.

<sup>7</sup> The negative effect of volatility on investment has been found statistically significant by a number of econometric studies (see, for example, Aizenman and Marion, 1999). Aghion *et al.* (2005) and Ramey and Ramey (1995) test econometrically the connection of volatility and growth, finding a significant negative relationship.

<sup>8</sup> Other two key connections are increases in potential productivity brought by technological change and the formation of human capital. It must be recalled that technology frequently needs to be embodied in factors of production (physical and human capital) in order to be part of the production function. Even intangible technology associated with the organization and generation of institutions usually requires investment in equipment and infrastructure, and depends on a more highly-skilled labor force.

utilization, rates of annual growth were calculated between 1980 and 2006, two years of relatively buoyant economic activity in the sample.<sup>9</sup> It is well documented that the increase in the capital stock accounts for much of GDP growth.<sup>10</sup> Moreover, most of the differences in growth between Latin America and the more dynamic countries of East Asia are attributable to the rapid growth in capital stock. That is, capital formation has been performing as a leading variable of the evolution of potential GDP in the economies that have been able to converge with the more developed nations. Figure 3 also illustrates the “disappointing” non-convergence of LACs with more advanced economies. In fact, the United States and East Asian economies have been growing faster than almost all LACs (where Chile is an outlier, but that only converges in the decade of the 1990s).

[Figure 3]

Another dynamic consequence of lower macroeconomic volatility is a tendency towards greater equity.<sup>11</sup> This links comprehensive real macroeconomic balances with the *macrosocial* balances (including poverty and income distribution). Indeed, low-income sectors, with less human capital, and small and medium-sized enterprises have less capacity to react to continuous unpredictable changes. During periods of expansion, the rate of inflation normally accelerates, and it is the poor who have problems protecting their assets and income against the “inflation tax”. The period of downward adjustment tends to be accompanied by drops in wages and employment, with a shift from formal toward informal markets (Tokman, 2004). Hence, there results a negative impact on consumption and wealth of low-income groups. A pro-cyclical behavior of the share of lower-income groups in overall consumption, but with a downward bias, should be expected under instability.<sup>12</sup> Instability is a significant source of inequity, and it rewards speculation and windfall gains, at the expense of productive activities and TFP.

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<sup>9</sup> We are assuming that all countries had rather similar high rates of utilization of factors in 1980 and 2006, in which case the rise in actual GDP is similar to that in potential GDP. That was not probably the case in countries that suffered GDP drops in one of the two years: Bolivia, El Salvador, Venezuela, the United States and Korea in 1980.

<sup>10</sup> The exceptions are Haiti, a country in turmoil as a result of internal conflicts that have conspired against the use of its productive capacity, and Paraguay, where the capital stock series are biased by the construction of huge dams, whose effect on production tends to be lagged over time. Barring these two cases, the explanatory power of the regression (measured by  $R^2$ ) increases to 92%.

<sup>11</sup> Inequality has, in turn, a negative effect on the formation of human capital, the quality of democracy and, consequently, on economic growth (Bourguignon and Walton, 2007; Alesina and Rodrik, 1994; Galor and Zeira, 1993).

<sup>12</sup> See, for example, Dutt and Ros (2005); Lustig (2000); Morley (1995); Rodrik (2001); Stewart (2005); World

Real volatility also has an impact on public finance, given that during recessions there is a drop in tax proceeds that has to be translated into cuts in expenditure (as happened during the debt, tequila and Asian crises). These cuts not only affect redundant and bureaucratic expenses, but also areas where spending was already insufficient, thus slashing expenditure which was essential for changing production patterns with social equity. In such areas as infrastructure, education and labor training, investment –whether public or private– is often far below the appropriate levels for economies which are undergoing major processes of change (see Easterly and Servén, 2003).

Maintaining excessive expenditure cuts in these essential items for several years undermines the efforts to improve factor quality and poses obstacles to the full utilization of installed capacity; thus, lowering the efficiency of the changes in production which are under way. As a consequence, economies operate with less dynamic production frontiers and in actual positions markedly below those frontiers. That is, their production capacity is under-utilized and tends to grow more slowly because of a lowered level of investment, with consequent negative impacts on actual productivity, employment and profitability.

The Latin American experience shows that an efficient combination of financial and real macroeconomic balances has been absent. In the 1990s, the success achieved in reducing inflation was partly due, in a number of cases, to exchange-rate appreciations, under the so-called *exchange rate anchor*. In fact, the vast majority of LACs revalued their currencies in real terms between 1990 and 1994, and again between 1995 and 1997. Renewed access to external finance in 1990-94 and 1996-97 made possible or actually encouraged successive real revaluations that acted as an anchor for the domestic prices of tradables. Furthermore, many countries that exhibited high rates of under-utilization of their productive capacity, with the renewed access to external finance and currency revaluations, were able to increase their rates of resource use while at the same time reducing inflation (see white arrows in panels A, B and C in figure 1). Supply available in non-exports was able to respond fast to the increased aggregate demand, with generally falling average rates of inflation.

Appreciation-cum-trade liberalization caused the recovery in aggregate demand, both of individuals and of firms, to be increasingly intensive in imports (see F-D, 2006, ch. IV; and

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Bank (2003).

ECLAC, 1998, ch. V). Imports thus went from a low level kept down by the previous recession to an excessively high level, particularly in the case of imported consumer goods whose relative prices were sharply reduced with liberalization.

In the countries that appreciated most, with bigger and faster-growing external deficits, led by financial flows, price stabilization tended to be more rapid. However, they also became more vulnerable, as the gap between domestic spending and actual GDP (the external deficit) grew wider and external liabilities rose apace. As was to be expected, external creditors became increasingly sensitive to political and economic “bad news” what led to crises in the external sector.

Thus, some countries suffered traumatic setbacks in the fight against inflation in 1995 (Mexico, for example) or sank into recessions (Mexico, once again, and Argentina). When timely corrections had been made, however, the necessary adjustments could be carried out without major upsets. For instance, Chile in 1990-95 carried out *mini-adjustments*, in a three-pillar macro approach, whenever it detected starting imbalances in order to avoid subsequent *maxi-adjustments*.

After the 1995 crisis, the return of capital flows to Latin America in 1996-97 allowed, once again, a simultaneous improvement in economic activity and in price stability, but at the expense of a rise in exchange rates and external deficits. The result was the subsequent penetration into *vulnerability zones*. Consequently, in 1998, when the Asian crisis did hit Latin America, there was a generalized downward adjustment in the region, especially in South America, with massive capital outflows and significant exchange rate depreciation. This time, however, inflationary processes did not take place. On the contrary, there appeared long-lasting large recessive output gaps as a result of contractive monetary policy, which gave priority to price stability over real stability (see panels A, B and C in figure 1).

The sharp GDP recovery of 5.5% in 2004-07 is undoubtedly a positive fact, but took place after six years of large disequilibria: the significant output gap in 1998-2003.<sup>13</sup> This fact, in that long six-year period, represents a costly failure of domestic macroeconomic policies by not

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<sup>13</sup> In 2004-07, pulled-up by a strengthened world economic activity and sharply improved terms of trade, a significant drop of the output gap took place. While potential GDP was expanding in the order of 3%, actual GDP rose 5.5% in that four-year period. Thus, the recessive gap, part of the previous macroeconomic disequilibria, was corrected.



keeping the economy close to the production frontier. That failure was compounded by the pro-cyclical behavior of international trade and finance.

## **2. EXTERNAL SHOCKS AND REAL MACROECONOMIC BALANCES**

In order to cope with real volatility it is crucial to understand its causes. External shocks are a major source of macroeconomic fluctuations in EEs. It is possible to identify at least three sources of positive external shocks, in front of which economic activity can respond positively, insofar as installed capacity is available. First, an increase in export prices. Once the production frontier has been reached, however, if the positive shock still persists it will cause demand pressures that give rise to higher domestic prices and/or an increased external deficit. As swings in external prices are largely transitory, however, if the economy accommodates to that abundance, the subsequent downward adjustment will be traumatic.

A second source of external shocks is changes in international interest rates. Depending on the capital account regime, these fluctuations affect domestic rates to some extent and their effects are thus transmitted through relative prices to aggregate demand; they influence the volume of net capital inflows, affect national income – since a drop (rise) in external interest rates increases (reduces) the national income of a net debtor country – and they affect the foreign currency market.

A third source of external shocks, which has been the main determinant of macroeconomic instability of LACs since the 1970s, are the sharp fluctuations in the volume of capital flows. In this respect, private capital flows other than FDI are particularly noteworthy because of their volatility.

Figure 4 show the systematic association between swings in aggregate demand and external shocks.<sup>14</sup> In other words, in recent decades, generally, real volatility has had an external origin: these have been notably stronger than domestically originated shocks. In the late seventies and in the nineties there were sizable capital surges, while in recent years are determined mostly by significant terms of trade changes. Figure 5 shows that changes of actual

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<sup>14</sup> The external shocks variable, is measured here as the higher (or lower) available resources as a result of net transfers from abroad and change in the terms of trade, as a share of GDP.

GDP have been sharply associated to fluctuations in aggregate demand. In the last four decades, aggregate demand changes have led GDP changes in both booms and recessions that have affected the region. Usually, only subsequently, domestic policies have played a role in moderating or exacerbating the effect of external shocks.

[Figures 4 and 5]

In fact, the causality has been twofold. On the one hand, shocks have been essentially exogenous. The overall supply of capital flows to EEs, the world interest rates and the main factors behind the evolution of the terms of trade (the growth of the world economy, exogenous supply of natural resources) are generally independent of economic policies in EEs. On the other hand, the exposure to shocks and the intensity of their effects are affected by some domestic factors. Indeed, the degree to which external shocks are reflected in GDP growth is strongly determined by i) the initial gap between actual GDP and the production frontier; ii) the nature of the domestic economic policies implemented, especially the macroeconomic ones; iii) the expectations of economic agents; and iv) political events.

In an "ideal" adjustment process, in a perfectly flexible and well-informed economy, with *complete* and homogeneous factor markets, excess aggregate demand is eliminated without any drop in production (or, more exactly, in the rate of use of capacity). On the other hand, in an economy that was underutilizing capacity in the tradable sector, an adjustment with a balanced mix of production and expenditure switching policies can raise output. Finally, in the typical setting of an economy with price inflexibility and imperfect factor mobility, the implementation of neutral demand-reducing policies usually leads to a significant drop in production, because such policies reduce demand for both tradables and non-tradables, thus giving rise to unemployment especially in the latter sector.

This confirms the importance of price inflexibility, factor immobility, incomplete markets and flaws in information during adjustment processes in the real economy. They explain why adjustment usually proceeds significantly below the production frontier.

In fact, in the real world, in adjustment processes intensive in demand reduction, there tends to be a drop in production which gives rise to a lower rate of utilization of installed capacity, and discourages capital formation (see figure 2, above). The addition of switching policies, which act over the composition of output and expenditure, can cushion the reduction of

economic activity. These policies may be rather global –such as the exchange rate– or they may be more sector-specific. The East Asian countries provide examples of success through extremely selective policies, and also of notably effective adjustment processes (Amsden, 2001; Kaplan and Rodrik, 2001). A mix of expenditure-reducing policies and switching policies should tend to make possible an outcome closer to a full utilization of potential GDP.

In periods of economic recovery, macroeconomic policy management seems to face lighter demands than when the economy is already at its production frontier. In fact, a passive policy can give positive net results in a situation under a recessive gap. Capital inflows (or improved terms of trade) increase the domestic spending capacity. Aggregate demand for domestic and imported goods expands in a context of improved expectations, fuelled by the access to foreign funds. The supply of domestic goods and services can respond to the greater demand thanks to the available installed capacity, while the resulting increased imports are covered by capital inflows.

Thus, under unemployment of productive factors, the positive shock has a positive Keynesian-type effects: it eliminates the binding external constraint (BEC), making possible a higher use of productive capacity, and thus leading to a recovery in output, income and employment (as well as investment, as documented in F-D, 2006, ch. III).

However, most crises since the 1980s have been the result of badly managed booms (Ocampo, 2003). During the boom is when the degrees of freedom to choose policies are broader and it is when future imbalances are generated. In order to move toward a macroeconomics-for-growth, we need to have a systematic clear differentiation between what is economic recovery and what is generation of additional capacity. This has been a common misleading factor for both leftist and rightist governments in Latin America. That pitfall leads, not only to neglect the importance of investment from the point of view of public policies, but also stimulates the private sector to run a *destabilizing intertemporal adjustment*. Indeed, interpreting that a recovery is a sustainable growth of potential GDP, supposedly with a high TFP, leads to feel richer and starting consuming the future, while not being really richer. Sharply distinguishing between creating capacity and using existing capacity should be guiding our macroeconomic policy.

In fact, if capital inflows or improved terms of trade stimulate processes of recovery in economies with unemployment of productive factors, actual productivity rises because of an

increase in the rate of utilization of potential GDP. Then agents and authorities (and also many researchers, see F-D, 2006, ch. III) may confuse the jump in actual productivity that is based on the utilization of previously idle labor and capital, with a structural increase in the sustainable speed of productivity improvements. From the point of view of ‘rational’ consumers, they tend to assume that there is an increase in their permanent income. Consequently, the market response would tend to be an intertemporal upward adjustment in consumption, with the external gap covered with capital inflows, as long as the supply of foreign savings is available. That implies a crowding-out of domestic savings that results from agents decisions based on biased information.<sup>15</sup> The intertemporal adjustment ends being destabilizing.

The increased availability of funds tends to generate a process of exchange rate appreciation (see figure 6). Then the expectations of continued, persistent appreciation encourage additional inflows from dealers operating with maturity horizons located within the expected appreciation of the domestic currency.<sup>16</sup> For allocative efficiency and for export-oriented development strategies, a macro-price -as significant as the exchange rate- led by capital inflows conducted by short-termist agents reveals a severe policy inconsistency. The increase in aggregate demand, pushed up by inflows and appreciation, and rising share of the domestic demand for tradables, augments artificially the absorptive capacity and the demand for foreign savings. Thus, exogenous changes (like fluctuations in the supply of funds) are converted into an endogenous process, leading to domestic vulnerability, given the potential reversibility of flows. In the case of a transitory improvement in the terms of trade, a similar destabilizing process can occur, with an excessive increase in consumption and a weakening in the generation of productive capacity in tradable sectors intensive in domestic inputs (Dutch disease).

[Figures 6]

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<sup>15</sup> As highlighted by Aghion and Durlauf (2007), the low savings ratios are behind the lack of conditional convergence of developing countries, and particularly LACs. We stress that low savings are, partly, a consequence of recessive gaps led by two-pillar macroeconomics and subsequent discouragement to productive investment.

<sup>16</sup> For short-termist agents the actual and expected profitability increases with the appreciation process. Therefore, it is most relevant, because of its policy implications, what happens with the behavior of exchange rates during the expansive of boom stage. It is then when external imbalances and currency mismatches are, inadvertently, being generated.

Therefore when actual output is reaching the production frontier, more active policies are needed to regulate the expansion of aggregate demand. Moreover, with a closing recessive output gap, the role of policies to enhance productive development (and increase potential output) becomes crucial. In fact, it is essential to keep the rate of expansion of demand in line with the growth of productive capacity (and also with sustainable external financing). Otherwise, if passive macroeconomic policies are adopted in situations of positive external shocks (such as lower international interest rates, improved terms of trade or increased supply of capital inflows) or of a domestic nature (a boom in the construction sector or in the demand for durable goods or stocks and bonds), then the economy will be subject to inflationary pressures and/or a growing gap between expenditure and output; in all events, a future adjustment in the opposite direction will usually be built up.

Thus, as the production frontier is being neared, there is a growing need for more active and efficient macroeconomic policies. Otherwise, what initially is an equilibrating macroeconomic adjustment becomes a source of disequilibrium and vulnerability.

In brief, it is necessary to further improve the capacity to implement real macroeconomic policies, in order to reconcile the proximity of the economy to the production frontier with sustainability and price stability: an effective pro-growth counter-cyclical policy mix. As documented by Kaminsky *et al.* (2004) for a sample of 104 countries, the opposite has tended to occur. Both monetary and fiscal policies (as well as the exchange rate) have been pro-cyclical and have exacerbated the effect of the shocks of capital flows.

### **3. FINANCIAL DEVELOPMENT, FINANCIERISM AND PRODUCTIVISM**

Financial development is a key ingredient for economic development.<sup>17</sup> Channeling financial resources toward sectors of higher productivity improves overall efficiency in the economy and enhances economic growth. However, financial markets are imperfect, and quite incomplete in EEs and more so in LDCs. In a world of uncertainty, incomplete insurance markets, informational costs and contagious changes of mood, *ex ante* and *ex post* valuations of financial assets may be radically different. The time gap between a financial transaction and payment for

it generates externalities in market transactions that can magnify and multiply errors in subjective valuations, to the point where finally the market corrections may be abrupt, overshooting and destabilizing (Stiglitz, 2000).

a) *Financierism empowered by neo-liberal reforms*

A distinctive feature of macroeconomic management, in the transition toward development of more advanced nations and in the most successful newly industrialized countries, has been the predominance of productive over financial dimensions. Development has been led by the “real” side, with financial aspects at its disposal. It is a policy correlation contrary to the neo-liberal approach and the standard thesis of financial liberalization as a leading essential input for development.

On the contrary, in EEs there has prevailed the phenomenon of “financierism” –that is, the dominance (or strong influence and powerful lobbying) of short-termist financial agents on macroeconomic decisions.<sup>18</sup>

The growing link with the international financial system facilitated the disassociation with the needs of domestic productive systems and encouraged capital flights during periods of domestic crises.

On the other hand, since the seventies, economic agents linked to the financial sphere gained greater overall influence in public and private enterprises, as well as in ministries and other governmental departments. This situation imposed the predominance at these levels of a short-termist bias over concerns for productivity and additions to productive capacity. A trend that was emphasized after the debt crisis, when foreign financial creditors and international financial institutions gained weight in the definition of domestic policies (see Devlin and Ffrench-Davis, 1995). In speculative markets, as Arrow (1974) pointed out, a considerable part of the efforts of economic agents focuses on acquiring information for personal benefit and leads to a zero sum or negative sum redistribution, owing to the use of real resources for these purposes.

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<sup>17</sup> See a recent contribution in Aghion and Durlauf (2007).

<sup>18</sup> See an interesting pioneer view developed in Bacha and Díaz-Alejandro (1983).

In short, total openness to the international market (such as those carried out in the nineties in most EEs) can dismantle comprehensive efforts at domestic stabilization and encourage capital flight (Dornbusch, 1991). In fact, it could imply integration into more speculative segments of developed world markets. In contrast, insertion into the world economy should be aimed at promoting long-term capital inflows, accompanied by access to technology and export markets.

From the mid-nineties, campaigning and elected Latin American Presidents became usual visitors to Wall Street. International mass media, in turn, began to talk about the “market’s candidate”; actually, just referring to financial markets. The strengthening of this dimension has provoked a growing duality, worrisome for democracy, in the constituencies taken into account by authorities in EEs. The present features of globalization are raising the distance between decision-makers and financial agents *vis-à-vis* the domestic agents (workers, firms and fiscal tax proceeds) that are bearing the consequences. Thus, an outcome of the specific road taken by globalization has been that experts in financial intermediation –a microeconomic training– have become determinant, in too many cases, for the evolution of the domestic macroeconomic balances and their volatility.

Pressures from international financial markets have pushed some governments to offer guaranties for financial investors as a mean to gain credibility away from what is consistent with growth and equity; even beyond what is necessary to achieve short run credibility with international financial markets. As shown by the Argentinean case in the 1990s, if public commitments are beyond the capacity that a democratic country can bear, the result may be praises in the short-term but a net loss in credibility in the medium and long term (see Neut and Velasco, 2003).

The case of Chile, in the return to democracy in 1990, is an outstanding example of differences between the productivistic and the financieristic dimensions: while domestic and foreign financial media praised liberalizing policies during the military rule of Pinochet, Chile recorded its lowest investment ratio in the last half century. On the contrary, the reforms to the reforms in the nineties –including regulation of financial inflows, some tax increases, labor reforms to strengthen workers bargaining power and significant increases in minimum wages– were received “with concern” by the large private entrepreneurs and the financial sector, while the investment ratio reached historical peaks. This successful combination was made possible by

adopting a three-pillar macroeconomics in the early 1990s. Contrarywise, in most of Latin America support of political authorities to the “market economy” has never been as explicit and strong as since the late 1980s, just in the period with historical minimum levels in investment ratios. These cases show that enthusiastic praise from financial markets has, frequently, not been useful for productive development. One outstanding failure has been the incapability to progress from two-pillar macroeconomics to three-pillar real macroeconomic balances.

*b) Rational pro-cyclicality of short-term financial markets; irrational macroeconomic followers of their advise*

It becomes highly unlikely to escape from financieristic traps without a traumatic adjustment. They usually involve an overshooting to outlier exchange or interest rates, and considerable liquidity constraints that, together, generate a very unfriendly macroeconomic environment for firms and labor.

An outstanding feature of most recent macroeconomic crises in East Asia and Latin America is that currency and financial crises have been suffered by EEs that usually were considered to be highly 'successful' by IFIs and financial agents.<sup>19</sup> Actually, they were awarded with growingly improving grades from international risk rating agencies;<sup>20</sup> accordingly, EEs were rewarded with large private capital flows, and falling spreads, in parallel with accumulating rising stocks of external liabilities.

Given that voluntary flows cannot take place without the willing consent of both debtors and creditors, why did neither agent act in due time to curb flows well before a crisis? The fact is that both regions moved into vulnerability zones (we repeat the signals: some combination of large external liabilities, with a high short-term or liquid share; a credit boom; currency and maturity mismatches; a significant external deficit; an appreciated exchange-rate; high price/earnings ratios in the stock market, high luxury real estate prices; plus low domestic investment ratios in the case of LACs). In parallel, as discussed below, agents specialized in

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<sup>19</sup> We develop this interpretation in Ffrench-Davis (2006, chapter VI). Complementary analyses are found in Frenkel (2004); Williamson (2003).

<sup>20</sup> Reisen (2003) shows that risk-rating agencies usually follow the market. Nonetheless, they play a significant role because they tend to reinforce over-optimism and over-pessimism.



microeconomic aspects of finance, placed in the short-term or liquid segments of capital markets, acquire a dominant voice in the generation of macroeconomic expectations.

There is an extremely relevant literature on the causes of financial instability: the asymmetries of information between creditors and debtors, and the lack of adequate internalization of the negative externalities that each agent generates (through growing vulnerability), that underlie the cycles of abundance and shortage of external financing (Krugman, 2000; McKinnon, 1991; Rodrik, 1998; Stiglitz, 2002; Harberger, 1985). Beyond those issues, as stressed by Ocampo (2003), finance deals with the future, and evidently concrete "information" about the future is unavailable. Consequently, the tendency to equate opinions and expectations with "information" contribute to herd behavior and multiple equilibria. Actually, we have observed a notorious contagion, first of over-optimism, and then of over-pessimism in many of the financial crises experienced by EEs in the last three decades.

During all three expansive processes there has been an evident contagion of over-optimism among creditors. As said, rather than appetite for risk, in those episodes agents supplying funding underestimate or ignore risk. With respect to debtors, in periods of over-optimism, the evidence is that most debtors do not borrow thinking of default and expecting to be rescued or to benefit from moratoria. Contrariwise, expectations of high yields tend to prevail: borrowers are also victims of the syndrome of financial euphoria during the boom periods.

However, over and above these facts, there are two additional features of the creditor side that are crucially important. One feature is the particular *nature of the leading agents* acting on the supply side. There are natural asymmetries in the behavior and objectives of different economic agents. The agents predominant in the financial markets are specialized in short-term liquid investment, operate within short-term horizons, and naturally are highly sensitive to changes in variables that affect returns in the short-run.<sup>21</sup> The second feature is the gradual spread of information, among prospective agents, on investment opportunities in EEs. In fact, agents from different segments of the financial market become gradually drawn into new

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<sup>21</sup> Persaud (2003), argues that modern risk-management by investing institutions (such as funds and banks), based on value-at-risk measured daily, works pro-cyclically in the boom and bust. Pro-cyclicality is reinforced by a trend toward homogenization of creditor agents. A complementary argument by Calvo and Mendoza (2000) examines how globalization may promote contagion by discouraging the gathering of information and by strengthening incentives for imitating market portfolio.

international markets as they take notice of the profitable opportunities offered by emerging economies previously unknown to them.

This explains, from the supply-side, why the surges of flows to emerging economies –in 1977-81, 1991-94 and mid-1995-98– have been *processes* that went on for several years rather than one-shot changes in supply. In this sense, it must be stressed the relevance for policy design of making a distinction between two different types of volatility of capital flows, short term ups-and-downs, and the medium term instability, which leads several variables –like the stock market, real estate prices and the exchange rate– to move persistently in a given direction, providing "wrong certainties" to the market and encouraging capital flows, *seeking economic rents* rather than differences in real productivity. Private capital flows; led by mid-term volatility (or reversibility) of expectations, usually have a strong and costly pro-cyclical bias.

On the domestic side, high rates of return were potentially to be gained by creditors from capital surges directed to EEs. At the time of their financial opening, in the 1980s and early 1990s, Latin American economies were experiencing recession, depressed stock and real estate markets, as well as high real interest rates and initially undervalued domestic currencies. Indeed, by 1990, prices of real estate and equity stocks were extremely depressed in Latin America, and the domestic price of the dollar was comparatively high (see ECLAC, 1998; French-Davis and Ocampo, 2001).

In the case of East Asia, when they opened their capital accounts during the 1990s, the international supply of funding was already booming. As compared to LACs, they were growing notably fast, with high savings and investment ratios. However, equity stock was also cheap as compared to capital-rich countries (exhibited low price/earnings ratios), and liquid external liabilities were extremely low. Naturally, the rate of return tends to be higher in the productive sectors of capital-scarce EEs than in mature markets that are capital-rich. Then, there is potentially space for very profitable capital flows from suppliers in the latter to the former markets. Flows should continue until rates of return (adjusted!!) converge, what naturally would take a long term. The direction of expected adjustments in any emerging economy moving from a closed to an open capital account, in those conditions, should tend to be similar to those recorded in LACs. The outcome in both emerging regions, for instance, was a spectacular rise in stock prices, multiplying in average the price index by four in 1990-94 and (after a sharp 40%

drop with the Tequila crisis) by two in 1995-97 in LACs, and by two in 1992-94 in East Asia (see F-D 2006, table VII.4). All these swings were directly associated to portfolio flows.

In what relates to domestic interest rates, they tended to be high at the outset of surge episodes, reflecting the binding external constraint faced by most countries during periods of sharp reductions in capital inflows, the restrictive monetary policies in place and the short-term bias of the financial reforms implemented in Latin America. Finally, in a non-exhaustive list, the increased supply of external financing in the 1990s generated a process of exchange-rate appreciation in most LACs (see figure 6, above), as well as, more moderately, in East Asia; the expectations of continued, persistent, appreciation encouraged additional inflows from dealers operating with maturity horizons located within the expected appreciation of the domestic currency.<sup>22</sup> The combination of open capital account, large liquid liabilities and expectations of depreciation lead, most naturally, to a large outflow, with a large depreciation if the rate is flexible.

For allocative efficiency and for export-oriented development strategies, a macroprice – as significant as the exchange rate– led by capital flows conducted by short-termist agents reveals a severe policy inconsistency. The increase in aggregate demand, pushed up by inflows and appreciation, and a rising share of the domestic demand for tradables, augments 'artificially' the absorptive capacity and the demand for foreign savings. Thus, as said, the exogenous change –opened by the transformations recorded in international capital markets– was converted into an endogenous process, leading to domestic vulnerability given the potential reversibility of flows.

In brief, the interaction between the two sets of factors –*the nature of agents and a process of adjustment*– explains the dynamics of capital flows over time: why suppliers keep pouring-in funds while real macroeconomic fundamentals worsen. When creditors *discover* an emerging market, their initial exposure is low or non-existent. Then they generate a series of consecutive flows, which result in rapidly increasing stocks of financial assets in the EE; actually, too rapid and/or large for an efficient absorption; frequently, the absorption is

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<sup>22</sup> For short-termist agents the actual and expected profitability were increased with the appreciation process. That same process, if perceived as persistent, would tend to discourage investment in the production of tradables intensive in domestic inputs. Therefore, it is most relevant, because of its policy implications, what happens with the behavior of exchange rates during the expansive or boom stage. It is then when external imbalances and currency and maturity mismatches are, inadvertently, being generated.

artificially increased by exchange rate appreciation, and a rising real aggregate demand with an enlarged external deficit as a consequence.

The creditor's sensitivity to negative news, at some point, is likely to, suddenly, increase remarkably when the country has reached *vulnerability zones*; then, the creditors take notice of (i) the rising level of the stock of assets held in a country (or region), (ii) the degree of dependence of the debtor market on additional flows, which is associated with the magnitude of the current account deficit, (iii) the extent of appreciation, (iv) the need of refinancing of maturing liabilities, and (v) the amount of liquid liabilities likely to flow out in face of a crisis. Therefore, it should not be surprising that, *pari passu* with a deeper penetration into vulnerability zones, the sensitivity to adverse political or economic news and the probability of reversal of expectations grows steeply (Rodrik, 1998).

The accumulation of stocks of assets abroad by financial suppliers, until well advanced that boom stage of the cycle, and, then, a subsequent sudden reversal of flows, can *both* be considered to be *rational* responses on the part of individual agents with short-term horizons. This is because it is of little concern to this sort of investors whether (long-term) fundamentals are being improved or worsened while they continue to bring inflows. What is relevant to these investors is that the crucial indicators from their point of view –prices of real estate, bonds and stock, and exchange-rates– can continue providing them with profits in the near term and, obviously, that liquid markets allow them, if needed, to reverse decisions timely; thus, they will continue to supply net inflows until expectations of an imminent near reversal build up.

Indeed, for the most influential financial operators, the more relevant variables are not related to the long-term fundamentals but to short-term profitability. This explains why they may suddenly display a radical change of opinion about the economic situation of a country whose fundamentals, other than liquidity in foreign currency, remain rather unchanged during a shift from *over-optimism* to *over-pessimism*.

Naturally, the opposite process tends to take place when the debtor markets have adjusted downward 'sufficiently'. Then, the inverse process makes its appearance and can be sustained for

some years, like in 1991-94 or 1995-97, or since 2004, or be short-lived like in late 1999 and 2000.<sup>23</sup>

In conclusion, economic agents specialized in the allocation of financial funding (I will call it microfinance, as opposed to macrofinance), who may be highly efficient in their field but operate with short-horizons "by training and by reward", have come to play the leading role in determining macroeconomic conditions and policy design in EEs. It implies that a 'financieristic' approach becomes predominant rather than a 'productivistic' approach. Growth with equity requires improving the rewards for productivity enhancement rather than financial rent-seeking searching for capital gains. There is need to rebalance priorities and voices.

#### **4. DOMESTIC POLICIES AND MACROECONOMICS FOR DEVELOPMENT**

Domestic macroeconomic policies face the challenge of achieving an environment of reduced macroeconomic volatility, sustainable fiscal and external accounts and price stability. This task is a major challenge since national authorities have lost several degrees of freedom as a result of liberalizing reforms in the last decades. As a consequence, the transmission of externally generated cycles has been exacerbated, especially from international capital markets.

Therefore, systematic efforts are needed to ensure that the funds received can be absorbed efficiently, associated with investment in productive activities, and with a suitable proportion of that investment in the production of tradables. All this calls for active monetary, foreign exchange and fiscal policies, strict prudential regulation and supervision of the financial system, and regulations governing capital flows, especially of short-term and liquid flows.

##### *a) Monetary Policy*

Monetary policy has increasingly taken the form of inflation targeting schemes (that is, a single anchoring approach) in EEs.<sup>24</sup> This trend has been, generally, accompanied by the adoption of

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<sup>23</sup> Vulnerabilities were still significant in EEs when negative signals reappeared in the world economy in 2000, including the subsequent downward adjustment in the USA and the Argentinean crisis.

<sup>24</sup> The conditions that usually define an inflation targeting scheme are: (i) adoption of the inflation target as the economy's only (or dominant) nominal anchor, (ii) operational independence in the conduct of monetary policy committed to attain the inflation target, (iii) technical capability to forecast inflation and react accordingly, and (iv) high levels of credibility (see for example, Corbo *et al.*, 2002).

flexible exchange rate regimes and an open capital account. The new policy mix imposes significant challenges to economic authorities, since it presents some crucial limitations regarding their counter-cyclical capabilities.

Inflation targeting schemes in small open economies (like those of most EEs, particularly small as compared to the huge size of international financial markets), present significant pro-cyclical features. Indeed, given the importance of capital flows on business cycles in EEs, the turning point of the cycle will be probably featured, in its upper part, by the emergence of strong expectations of depreciation and downward pressures on aggregate demand and output and, in its lower part, by strong expectations of exchange rate appreciation and a recovery of aggregate demand and GDP. Given the fact that, in more open economies, the incidence of the exchange rate in the general price index is greater, the expectations of exchange rate depreciation (appreciation) will also be associated with expectations of upward (downward) inflationary trends. Consequently, the incentives of a Central Bank with a single nominal target will be biased towards implementing a contractionary policy just when the economy begins to experience the downward part of the cycle, and toward applying an expansive monetary policy during a recovery led by capital inflows; that is an straight pro-cyclical approach. Pro-cyclicality implies, given the asymmetries around potential GDP, an average of actual GDP below the average potential GDP.

Thus, a first challenge in the implementation of the monetary policy regime should be the elimination of this pro-cyclical bias. There are a number of possible solutions to deal with this issue. For example, the use of a domestic price index instead of a general price index in the definition of the inflation target (Parrado and Velasco, 2002) or the consideration of a long run inflation target to filter the transitory effects, for instance, of exchange rate and oil price fluctuations, and their impact on CPI. Also, it is possible the inclusion of targets on external deficits (Marfán, 2005) in order to deter the transmission of volatility from capital flows to domestic output, or the implementation (or strengthening) of real targets like the level of employment or the consistency of actual GDP with its potential level.<sup>25</sup>

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<sup>25</sup> Other point refers to the weight of every variable in the policy reaction function of the Central Bank. Under hyperinflation, its defeat should receive an overwhelming weight; under low or moderate rates of inflation, additional efforts to reduce it may have minor benefits and increasing costs.

As a matter of fact, Chile –frequently highlighted as a successful inflation targeteer since the late nineties (Mishkin and Schmidt-Hebbel, 2002)– applied a pragmatic formula to reduce inflation, which was quite far from being solely based on the inflationary goal. Indeed, in addition to a formal inflation target (which aimed at a moderated rather than an abrupt reduction), used an informal target in the current account deficit (around 3% of GDP), and an exchange rate band to avoid excessive appreciation, in combination with a monitoring of the aggregate demand behavior. This comprehensive counter-cyclical policy was quite systematic in the first half of the 1990s, and loosed coherency only gradually, during the rest of the decade (F-D, 2002).<sup>26</sup>

However, even if the pro-cyclical bias is eliminated by adopting a set of goals (multi-anchoring), the problem of an insufficient power in monetary policy, and long lags of its effects, may remain. Indeed, a redefinition of the targets of monetary policy will be insufficient to develop a counter-cyclical policy if the Central Bank is unable to powerfully affect domestic expenditure in the short and medium term.

During a boom, if monetary policy is managed to regulate aggregate demand by raising interest rates, then residents will try to finance their investment projects with external credits, and short-term foreign investors will be attracted by a higher interest rate differential (frequently widened by expectations of exchange rate appreciation). As analyzed, capital flows may have a great stimulating effect in economies under significant output gaps and liquidity constraints (see Ffrench-Davis and Tapia, 2005). In this context, high real interest rates use to live together with a troubled tradable sector (because of RER appreciation) and a boom in aggregate demand and in non-tradable output, financed with external savings that typically crowd-out domestic savings. The policy failure shows up when actual GDP approaches the production frontier. The experience of LACs in the nineties, under a strong capital surge, was paradigmatic in this sense (Uthoff and Titelman, 1998).

During a bust, in turn, the capacity of monetary policy to face shocks is even more restricted, especially if the country is already in *vulnerability zones*. Textbook theory states that a fall in the domestic interest rate, given the international rate, would cause capital outflows that

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<sup>26</sup> Even from the point of view of developed closed economies, overemphasis in price stability is suboptimal. If, for example, there are labor market frictions, the Central Bank should also focus on reducing unemployment. See a

will depreciate the exchange rate. Depreciation would favor the recovery in tradables output, stimulating overall GDP. In practice, however, in the short run the negative effects of depreciation on overall consumption and balance sheets are usually stronger than the positive pulls on tradables. If, on the contrary, monetary policy is used to stop the capital flight, the interest rate can be effective on the aggregate demand control (aggravating a recession), and ineffective on the capital flows under strong expectations of depreciation and contagion of pessimism. For instance, in order to compensate an expected devaluation of say 10% during one week it is needed a short-term interest rate exceeding an annual equivalent of well over 500%.

In summary, the effectiveness of counter-cyclical monetary policy in a context of open capital account and flexible exchange rates is quite limited.<sup>27</sup> The main policy implication of our analysis is that it is crucial to regulate capital flows as a way of making room simultaneously for complementary counter-cyclical exchange rate, fiscal, and monetary policies.

#### *b) Exchange rate regime*

The exchange-rate regime, particularly after trade liberalization, has become an increasingly influential variable in EEs, both on trade and finance. It is subject to two conflicting demands, which reflect the more limited degrees of freedom that authorities face in a world of reduced policy effectiveness (see ECLAC, 2002). The first demand comes from trade: with the dismantling of traditional trade policies (tariff and non-tariff restrictions), the real exchange rate has become a key determinant of international competitiveness and a crucial variable for an efficient allocation of resources into tradables.

Indeed, a “competitive” and stable RER is an input for a sound trade development.<sup>28</sup> A rather depreciated real exchange rate improves export competitiveness, and its stability favors productive investment in tradables and higher value-added activities.<sup>29</sup> However, in the last

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theoretical discussion in Blanchard and Gali (2006).

<sup>27</sup> See also Fischer (2006), who discusses the limits of the “independent monetary policy” in a context of floating exchange rate and inflation targeting.

<sup>28</sup> These goals are also present in the “Washington Consensus” Decalogue, published by John Williamson in 1990. Williamson (2003) is highly critical of this inconsistency in the implementation of the Washington Consensus.

<sup>29</sup> Studies by Caballero and Corbo (1990), ECLAC (1998, ch. IV), Williamson (2000), Eichengreen (2007) and Rodrik (2007) have proven or discussed sympathetically the validity of this approach. For exports intensive in imported inputs there is a natural matching between revenues and costs in foreign currency. In the case of exports based on natural resources, static comparative advantages (economic rents) are stronger enough to resist exchange



decades, short-term macroeconomic management and the reform agenda have been inconsistent with those goals linked to long-term development. In fact, in a number of countries, trade liberalization measures were accompanied by the liberalization of the capital account, which during the 1990s prompted considerable exchange-rate appreciation (see figure 6, above) just when trade reforms urgently required a depreciation. The positive connection between a competitive level of the RER and success in economic growth of EEs has been documented by Rodrik (2007), Hausmann *et al.* (2005), and Williamson (2000). It is noteworthy how the two extreme proposals in fashion (corner solutions) disregard these relevant facts.

The second is from the capital account. Volatility in international financial markets generate a demand for flexible macroeconomic variables to absorb, in the short run, the positive and negative shocks generated during the cycle. Given the reduced effectiveness of monetary policy, the exchange rate can play an essential role in helping to absorb shocks. This objective cannot be easily reconciled with the trade-related goals of exchange rate policy; particularly, of a growth strategy based on export expansion and diversification. Intermediate regimes of managed exchange-rate flexibility –such as crawling pegs and bands, and dirty floating– attempt to reconcile these conflicting demands (see Ffrench-Davis and Ocampo, 2001; Williamson, 2000).

Completely rigid exchange rate systems tend to amplify external shocks, because they put too unrealistic requirements on domestic flexibility, in particular on wage and price flexibility in the face of negative shocks. Currency boards certainly introduce built-in institutional arrangements that provide for fiscal and monetary discipline, but they radically reduce any room for stabilizing monetary, credit and fiscal policies, which are all necessary to prevent crises during mid-term capital surges and to facilitate recovery in a post-crisis environment. Convertibility (à la Argentina in 1991-2001 and Chile 1979-82), allows the domestic transmission of external shocks, generating strong swings in economic activity and asset prices, with the corresponding domestic financial vulnerability. There is an amplification effect when agents consider that an external shock that is strong enough can induce authorities to modify exchange rate policy; this is particularly so when the rate appears to be an outlier price, too appreciated (see Ffrench-Davis and Larraín, 2003).

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rate swings. In contrast, for high value-added exports (for example, for those labor-intensive), the exchange rate is key in defining their competitiveness.

Notwithstanding the pitfalls of the family of nominal pegs, there are cases in which it can work efficiently. The currency board in Argentina, assisted by the capital surge to LACs since the early 1990s, was quite effective in contributing to defeat hyperinflation, evidently the more harmful problem of that economy in 1991. The most severe mistake of the Argentinean authorities –encouraged by the subsequent good ratings and misleading appraisals received from IFIs– was not to use the opportunity provided by the international environment, in 1992 or 1993 and again in 1996-97, to flexibilize the exchange rate when inflation and the budget already were evidently under control, capital inflows were vigorous and spreads to EEs, quite explicitly including Argentina, were falling. It was an opportunity to shift to an intermediate regime and regain the exchange rate as a macro-policy tool.

On the other hand, the volatility characteristic of freely floating exchange rate regimes is not a severe problem when market fluctuations are short-lived; in such case they are easily faced with derivatives (see Dodd and Griffith-Jones, 2006). But fluctuations become a major concern when there are longer waves, a longer-lasting process, as has been typical of the access of EEs to capital markets in recent decades. In this case, persistent appreciation of that macro-price during capital surges tends to generate perverse effects on resource allocation of irreversible investment. Moreover, under freely floating regimes with open capital accounts, counter-cyclical monetary policy exacerbates pro-cyclical exchange rate fluctuations, with significant costs derived from an inefficient resource allocation and losses in income and output.

The ability of a flexible exchange rate regime to smooth out the effects of externally-induced boom-bust cycles, thus depends on the capacity to effectively manage a counter-cyclical monetary policy without enhancing pro-cyclical exchange rate patterns. This is only possible under intermediate exchange rate regimes-cum-capital account regulations. That was, clearly, the successful case of Chile in the first half of the 1990s (see Ffrench-Davis, 2002, ch. 10; Le Fort and Lehmann, 2003).

In many cases bands did not behave well during the Asian crisis. That was partially induced by the actual management of the crawling band. The huge increase in capital inflows to EEs, that took place between 1990 and 1997, did put severe upward pressure on exchange rates. The frequent response, in terms of expanding the size of the band or appreciating it, induced a

credibility loss.<sup>30</sup> Subsequently, bands already with a too appreciated rate, –and domestic economic structures growingly accommodated to that relative price change– had trouble in adapting to the sharp shift in the market mood brought by the Asian crisis, when capital inflows suddenly stopped. These facts induced a further credibility loss.

Obviously, intermediate regimes may also generate costs and exhibit shortcomings. First, intermediate regimes are subject to speculative pressures if they do not achieve credibility in markets; in critical conjunctures, particularly after the rate has clearly become an outlier price, the costs of defending the exchange rate from pressures are very high. Then, it may be advisable to move, *temporarily*, to full flexibility. Second, sterilized reserve accumulation during long booms may also become financially costly. The risk rises in EEs which tend to increase TFP faster than their trade partners, implying gradual equilibrating appreciation. Lastly, the capital account regulations needed to manage intermediate regimes efficiently reduce those costs, but are only partially effective. However, all things considered, intermediate regimes offer a sound alternative to costly outlier macro-prices derived frequently from corner solutions and untamed volatility.

A policy suitable for a given macroeconomic environment may not be so in another. In this sense, one crucial element to bear in mind when adopting a given policy is how costly it may be to switch to an alternative policy if needed (Ffrench-Davis and Larraín, 2003). As shown above, as in the Argentinean case, pegs may be useful under a critical hyperinflation and plentiful supply of external funding. With a peg and a recessive gap, capital surges create a demand boom, pulling-up asset prices, probably with a crowding-out of domestic savings and a worsening of the external balance (see Frenkel, 2004). Under a floating regime, a nominal appreciation will tend to follow after a capital surge making the process of real appreciation deeper (and henceforth potentially more disruptive) than with a peg. Pegs tend to work better than floats in the upward phase of the cycle, but after the inflection point the float does it better in terms of the necessary expenditure switching.

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<sup>30</sup> That policy reaction was, most probably, encouraged by the strong belief in fashion that financial crises were gone for long (or forever?). Recall, for instance, the proposal by the IMF, under the pressures from the Treasury of the United States and Wall Street, to change its articles of agreement in order to force member countries to across-the-board capital account opening (see a robust criticism to those pressures in Bhagwati, 2004, pp. 204-5).

Floating systems are useful in times of financial distress, when authorities have severe doubts concerning the level of the real rate, or the nature of the shock they face; flotation allows them not to put in jeopardy their reputation defending a wrong price. Finally, bands or managed flexibility contribute to stabilize the real exchange rate, improving its allocative efficiency.

In brief, large deviations from equilibrium of the real exchange rate are costly for the real economy. Central Banks should be concerned with both the level and the stability of this macro-price. In this sense, despite the road of full flexibility taken by several LACs since the Asian crisis, managed flexibility, with or without bands, is still a policy to be considered by policy-makers. They need to be reticent with across-the-board liberalization of the capital account since the need for real macroeconomic balances is really a priority. Indeed, the actual behavior of capital flows tends to be inconsistent with real macroeconomic stability, particularly in terms of the sustainability of the exchange rate and economic activity. In this sense, authorities need to adopt flexible policy packages rather than single rigid policy tools (Ffrench-Davis and Larraín, 2003).

*c) Fiscal policy*

Fiscal authorities need to provide financing to public goods in a framework of uncertainty and volatility. Indeed, fiscal policy should look at macroeconomic instability in two senses. On the one hand, since public revenues and expenditures are sensitive to business cycles, it is crucial to ensure a path of public expenditure consistent with the transitory needs that surge during the downturn (social subsidies) and with stable fulfillment of the permanent goals of the government (regular budget, including public investment). On the other hand, fiscal policy has also a macroeconomic role, in terms of the sustainability of public accounts and the regulation of aggregate demand. Given the progressive weakness of monetary policy to regulate aggregate demand (see above), the macroeconomic role of fiscal policy should not be neglected (see Krugman, 2005; Stiglitz, 2005).

Fiscal policy has been at the core of the debate on adjustment programs in EEs. Both in East Asia and Latin America the more conventional recipes recommended achieving current or annual fiscal balances, under recessionary conjunctures that had depressed tax proceeds. That is a typically pro-cyclical behavior. In recession, usually fiscal policy has been directed towards

keeping under control financial solvency, while during booms expenditure has frequently been expanded (Kaminsky *et al.*, 2004; Martner and Tromben, 2004; Singh, 2006).<sup>31</sup> This pro-cyclical stance tends to restrict the room for social programs and the scope of public investment during recessive periods and, in doing so, strengthens the negative effects of volatility on living standards and future economic growth. In addition, a pro-cyclical fiscal policy has exacerbated the boom and deepened the bust in the private sector, increasing macroeconomic instability and complicating the functioning of monetary and exchange rate policies.

As part of a counter-cyclical policy package, the concept of *structural fiscal balance* is the most outstanding fiscal component. There are different varieties, but the essential component is the measurement of the balance across the business cycle, estimating at each point of time what would be the public expenditure and income in a framework of sustainable full employment of human and physical capital. If the terms of trade fluctuations are relevant for fiscal proceeds –via profits of public or private exporters– the purchasing power of potential GDP should be estimated at the trend terms of trade. Given a tax burden, that trend must guide the evolution of public expenditure (see Budget Office of Chile, 2001).

Developing countries typically concentrate their trade on a few commodity exports, which are subject to highly volatile market prices. Especially, when a significant export –like copper in Chile, and oil in Colombia, Mexico or Venezuela– is public property, the establishment of a stabilization fund can contribute to both fiscal and overall macroeconomic sustainability. Also the coffee fund in Colombia has played, for long, a significant stabilizing macroeconomic role; since coffee is privately owned, the fund contributes directly to stabilize the current account and private domestic expenditure. Above the trend or "normal" public proceeds from those sources are saved in these funds, so to finance expenditure when proceeds are below "normal". It is highly recommended to initiate it in a scenario of high prices in comparison to trend prices, so that the fund could actually finance subsequent negative price scenarios.

All the mentioned measures help to develop a cyclically-neutral fiscal policy, where current expenditure is stabilized by linking it to its structural level. In persistent recessive

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<sup>31</sup> This is consistent with the fact that, in boom stages, fiscal balances have tended to improve. See, again, Marfán (2005).

situations, however, it would be desirable if governments decide to carry out expansive shocks of (transitory) expenditure increases and/or tax reductions, thus running contemporaneous structural deficits, in order to stimulate domestic demand.<sup>32</sup> Moving further, flexible tax rates have been proposed as an additional counter-cyclical device. For instance, it has been proposed to increase the VAT rate during booms and to compensate it with rate cuts during slack periods (Budnevich, 2003).

Fiscal policy ought to be part of the flexible policy package. Given that EEs are especially vulnerable to external shocks, over reliance on monetary policy may bring poorer macro results, as compared to a more balanced framework of counter-cyclical fiscal, exchange rate, and monetary policy, as well as prudential regulation of capital flows. The use of counter-cyclical fiscal policy requires as a precondition to be on a path of solvent and sustainable fiscal accounts. Moreover, to spread the adjustment burden between fiscal, foreign exchange and monetary policies, may bring better macroeconomic results, with each macro-price (interest and exchange rates) closer to sustainable equilibria and an actual GDP closer to its potential level.

*d) Regulation of capital flows and financial institutions*

It is crucial to ensure that the volume of inflows is consistent with the absorptive capacity of the host country. The failure to address this point is at the core of recent macro-instability in EEs. Absorption capacity must refer to both the use of existing productive capacity and to the creation of new one. The composition of flows is relevant on three dimensions. First, greenfield FDI (excluding acquisitions of existing assets) feeds directly into capital formation (usually intensive in imported capital goods), as do long-term loans to importers of capital goods. Second, volatile flows tend to impact more directly on foreign exchange and financial assets and real estate markets; they carry a weaker association to capital formation, which requires long-term financing (see Uthoff and Titelman, 1998). Third, temporary capital surges tend to leak into consumption, due to the faster release of liquidity constraints and capacity of consumers to respond as compared to the more lagged response of irreversible productive investment.

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<sup>32</sup> The case of Korea in 1998, when the fiscal deficit reached 4.2% of GDP, is useful to illustrate this approach. When the economy recovered, the fiscal balance returned to a surplus (Mahani *et al.*, 2006).

Allowing an excessively large share of capital inflows to drain off into the stock exchange and consumption of imported goods, will usually create bubbles in asset markets and imbalances in the external sector, which tend to generate growing vulnerability. Particularly, fast rising stocks of net liquid foreign liabilities generate deep vulnerabilities. Consequently, higher ratios of stable long-term flows and of productive investment imply a higher capacity for efficient absorption. Under these conditions of composition and stability, the domestic economy can absorb more efficiently a higher volume of capital flows.

Capital account regulations may perform as a prudential macroeconomic tool, working at the direct source of boom-bust cycles: that is, unstable capital flows. If effective, they provide room for action during periods of financial euphoria, through the adoption of a contractionary monetary policy and reduced appreciation pressures. If effective, they will also reduce or eliminate the usual quasi-fiscal costs of sterilized foreign exchange accumulation. What is extremely relevant is that, in the other corner of the cycle, of binding external constraints, they may provide space for expansionary monetary and fiscal policies.<sup>33</sup>

Overall innovative experiences in the 1990s of across-the board price restrictions on liquid and short-term financial inflows, indicate that they can provide useful instruments, both in terms of improving debt profiles and facilitating the adoption of counter-cyclical macroeconomic policies. They are directed to provide a rather more stable macroeconomic environment during the boom and minimizing the costly adjustment during downturns from overheated disequilibria. They provide a more market-friendly environment for (i) irreversible investment decisions; (ii) avoiding significant output gaps between actual and potential GDP; (iii) avoiding outlier macro-prices (exchange and interest rates), and (iv) discourages outlier macro-ratios (deficit on current account/GDP; price/earnings ratios of equity stocks; net short-term and liquid external liabilities/international reserves).

The discussion on capital controls intensified with the well-known action of Malaysia, in 1998, imposing tough non-price regulations on outflows. Data supports the view that they were effective in contributing to the sharp GDP recovery in 1999 (Kaplan and Rodrik, 2001). They

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<sup>33</sup> The market rewards sound external debt structures, because, during times of uncertainty, the market usually responds to *gross* financing requirements, which means that the rollover of short-term liabilities is not financially neutral (see Ocampo, 2003).

were determinant in making feasible the active fiscal and monetary policies implemented by Malaysia.

But, it is not enough to learn to get away from a crisis after suffering it. More important for significantly reducing the negative effects is to avoid the generation of external crises.<sup>34</sup> That is the role of regulations on inflows so to deter macro-policies and ratios from penetrating into vulnerability zones. The positive ‘market-based’ experience of Chile in the first half of the 1990s is one outstanding case (see Agosin and Ffrench-Davis, 2001). On the other hand, traditional exchange controls, as in China and India, (e.g. quantitative restrictions on short-term financial borrowing and diverse regulations in other inflows and on outflows by domestic agents) have worked quite efficiently for the objective of macroeconomic policy to significantly reduce the domestic macroeconomic sensitivity to international financial volatility.<sup>35</sup>

Prudential regulation and supervision (PRS) of domestic financial institutions that usually is designed under microeconomic concerns, also have macroeconomic implications. Consequently, PRS should take into account not only microeconomic risks, but also the macroeconomic risks associated to boom-bust cycles (Griffith-Jones, 2001; Ocampo, 2003). In particular, counter-cyclical devices should be introduced into prudential regulation and supervision. Aside the standard regulations on currency and maturity mismatches, they should involve a mix of: (i) forward-looking provisions for latent risks, on the basis of the credit risks that are expected throughout the full business cycle; (ii) more discretionary counter-cyclical prudential provisions decreed by the authority on the basis of objective criteria (e.g., the rate of growth of credit as compared to GDP); (iii) counter-cyclical regulation on the prices used for assets given in guarantee, and (iv) capital adequacy requirements focused on long-term solvency criteria rather than on cyclical performance.

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<sup>34</sup> In 1997, the then Minister of Finance of Canada, Paul Martin (1997), declared that “we have devoted almost all our time to make globalization happen and not to make it work right”; “we are spending energy in solving crises rather than avoiding them”.

<sup>35</sup> In liberalizing the capital account, a dose of prudent selectivity may also be necessary with regard to outflows, especially from privately-managed pension funds. These funds are increasingly allowed to invest abroad. The experience of Chile indicates that this may be dangerous, since these achieve microeconomic risk diversification at the expense of macroeconomic volatility (see F-D, 2006, chapter IX; Zahler, 2006).



#### 4. CONCLUDING REMARKS

EEs are living a sharp paradox, with a consensus on the importance of macroeconomic balances, and a common situation in which the outcome has been costly disequilibria for large segments of the real economy, that is, of labor and physical capital.

In order to deal with these inefficiencies, we need a *macroeconomics for sustainable growth* or *real macroeconomics*, focused not only on the stabilization of the price level and on the control of fiscal deficits (as stated by the mainstream approach), but also on external balances (key in open economies) and real variables, which affect the nexus between present and future. The main real balance is the use of the productive capacity (i.e. the employment of productive factors, capital and labor, at their potential level), since it is crucial in the evolution of actual income, social equity, structural or 'full employment' tax proceeds, capital formation and future growth.

The gap between the productive frontier and its rate of use implies a gross macroeconomic inefficiency, reflected in underutilized installed capacity in firms, unemployment of the labor force and reduced actual total factor productivity. A notorious effect of these recessive situations, usually, has been a subsequent sharp reduction in investment ratios, deterioration of labor skills and a rise in social inequality.

Real macroeconomic balances –including an aggregate demand consistent with productive capacity, sustainable (non-outlier) exchange rates and interest rates, fiscal responsibility and moderate inflation- are essential for growth and equity. Given the pro-cyclicality of financial flows (and the terms of trade), achieving those macroeconomic balances has as one requisite the comprehensive regulation of capital flows. The positive outcome is a macroeconomics for development. Naturally, when facing the need of regulating volatile financial globalization, developing nations must benefit from the availability of several alternatives, and choose a flexible set of policies, strongly counter-cyclical, that fit well with their economic structures, the degree of development of their markets, and the democratic objectives of their respective society.

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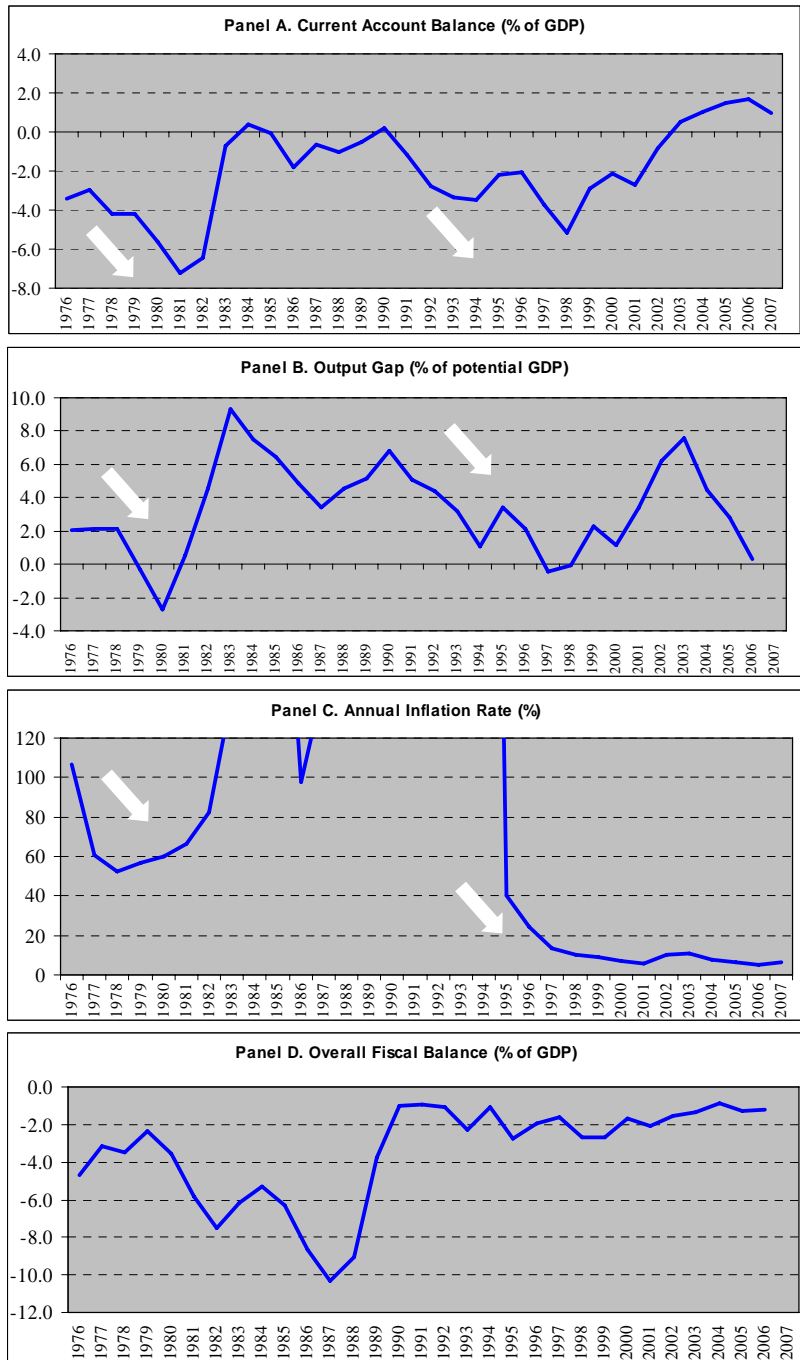
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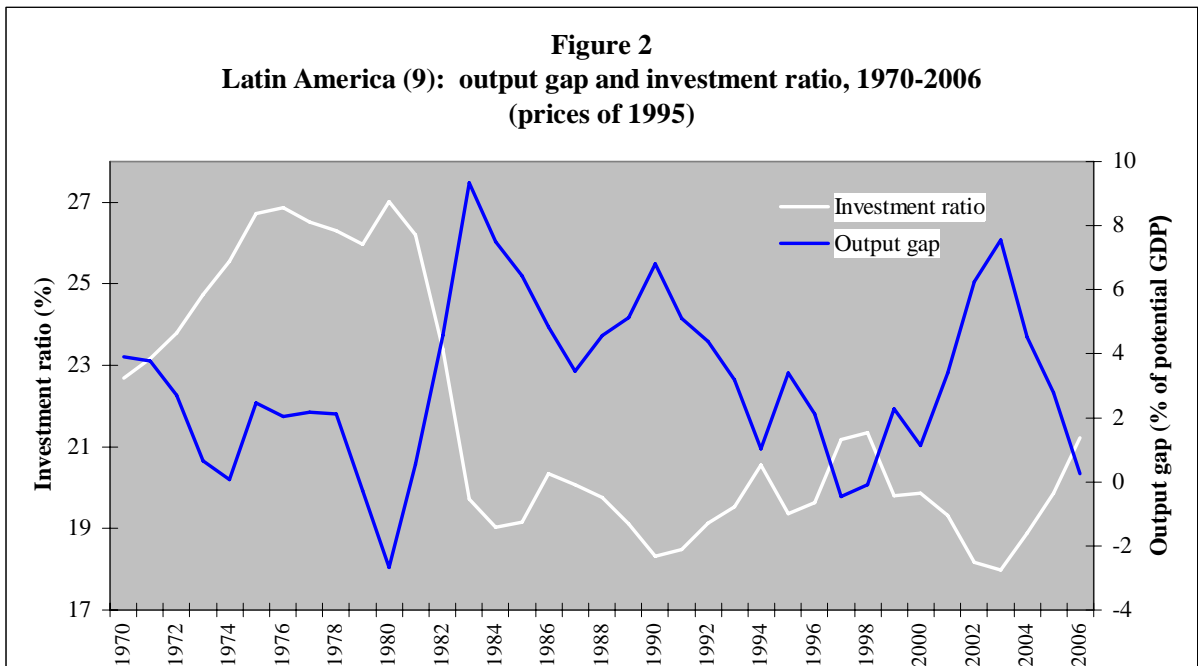


**Figure 1**

**Latin America (9): macroeconomic balances, 1976-2007**  
(weighted averages)



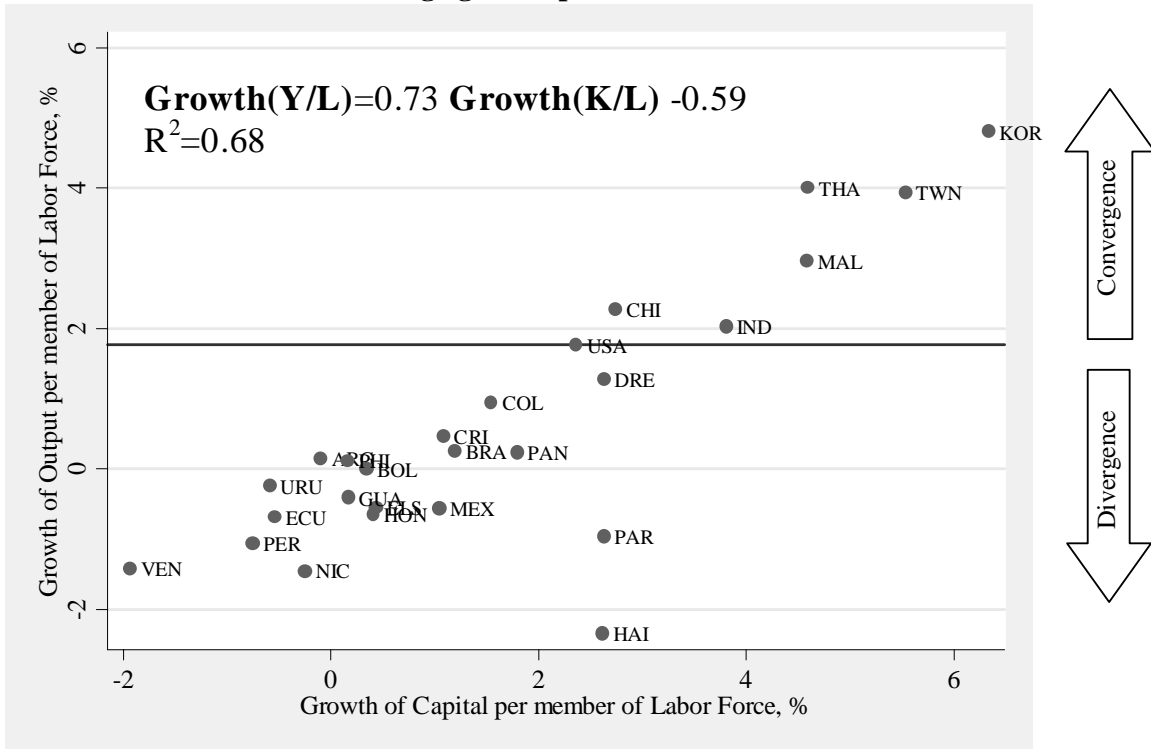
Source: Author's calculations based on ECLAC data and Hofman and Tapia (2004). Includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, México, Perú and Venezuela. Averages were weighted using GDP at 1980 constant prices.



Source: ECLAC and Hofman and Tapia (2003), and updates.

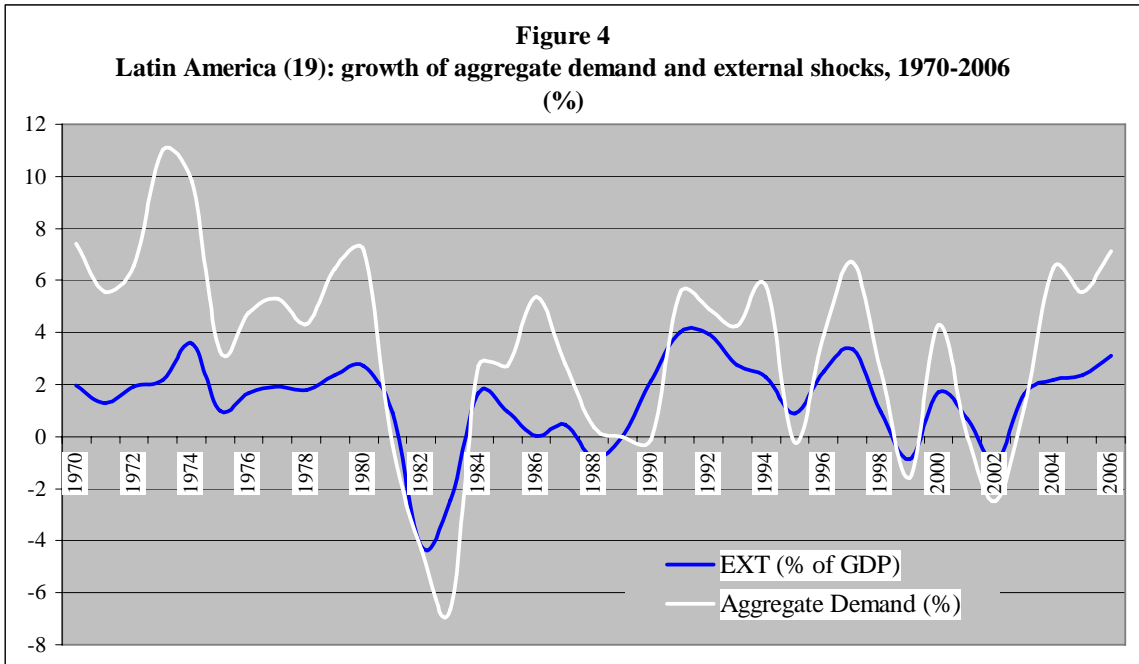
Averages for Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Venezuela. The investment ratio measures the ratio between the fixed capital formation and the GDP. The output gap measures the difference between potential and actual GDP as a share of potential GDP.

Figure 3  
**EEs and USA: Capital stock and GDP growth, 1981-2006**  
 (annual average growth per member of the labor force)



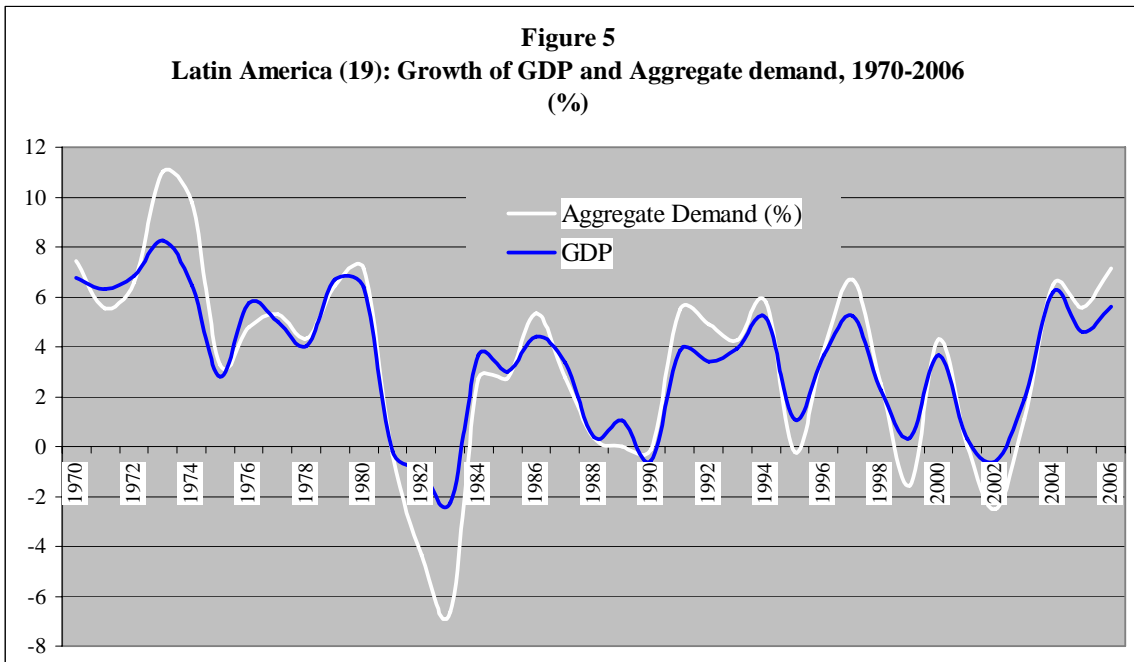
Source: Author's calculation.

Both the stock of capital and GDP are measured in 1995 prices. Capital stock was calculated through the perpetual inventory method assuming an average working life for capital of 30 years.

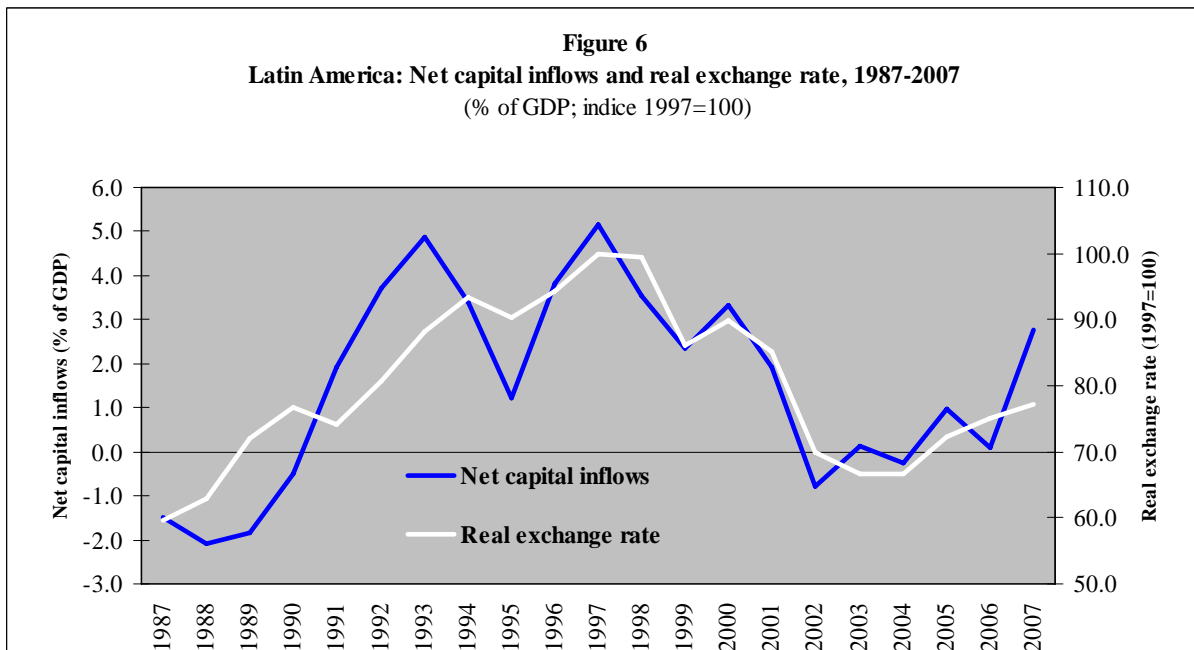


Source: Author's calculations based on data from ECLAC.

EXT: external shocks, represents additional resources from abroad, resulting from net transfers (capital inflows plus factor payments) and the improvement of the terms of trade. Measured as a share of GDP.



Source: Author's calculations based on data from ECLAC.



Source: Author's calculations based on ECLAC figures. Real exchange rate defined in terms of dollars per unit of local currency.